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July 1989

Railway Age

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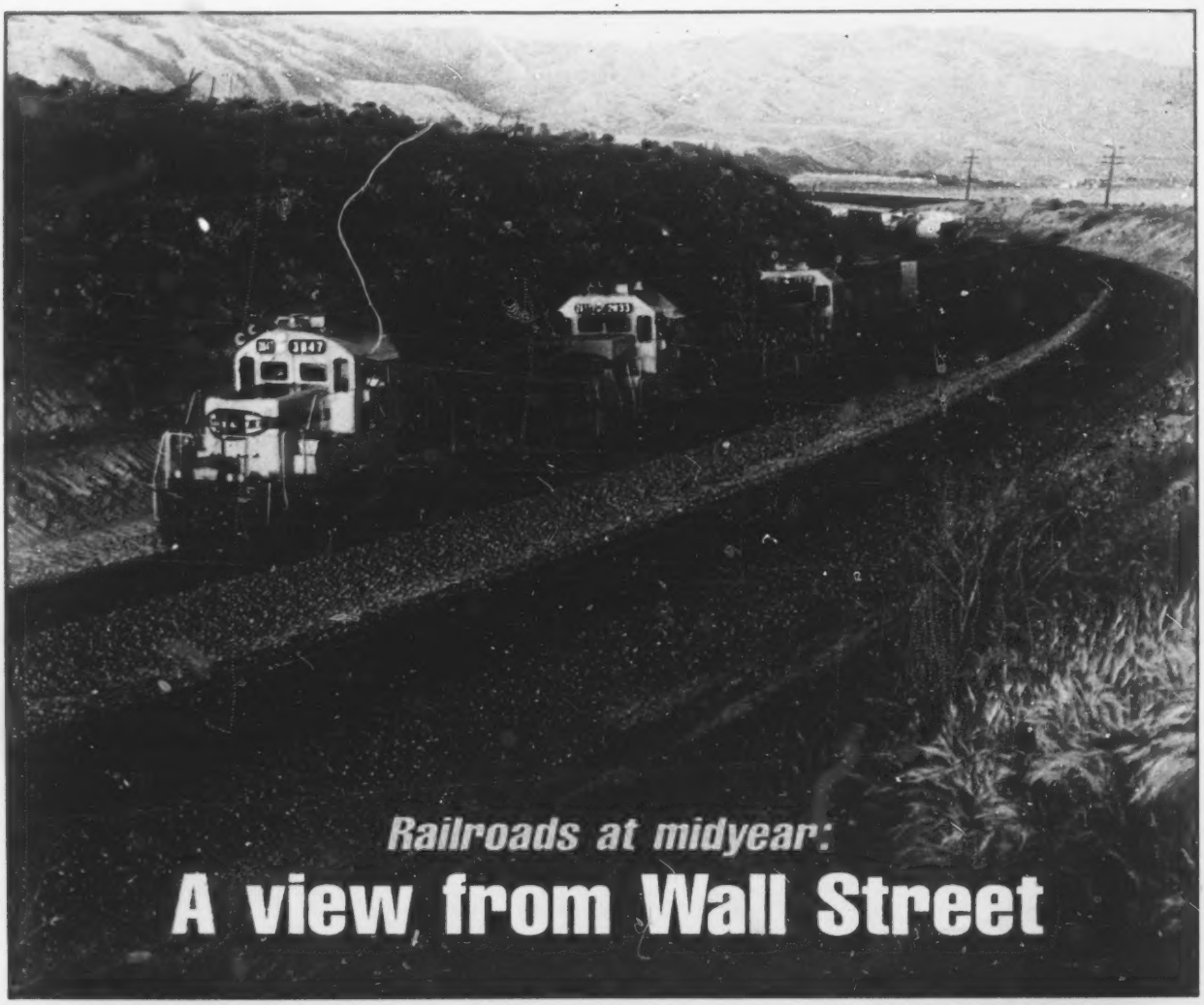

Railroads at midyear:
A view from Wall Street

BN's Technical Training Center:
"The best" gets better

Car & Locomotive Repair Directory

TTC seeks to expand as more riders climb aboard

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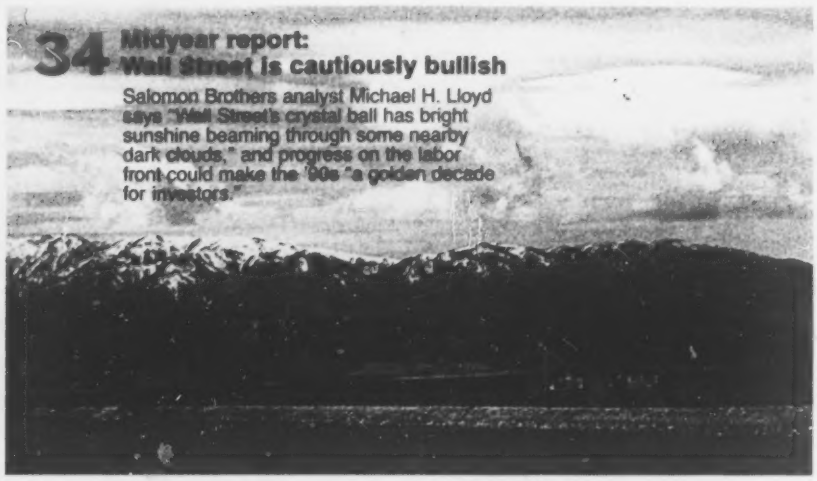

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INSIDE

Railroads at midyear, and beyond

LUTHER S. MILLER

"Cautious optimism" is a term we're all familiar with. It means that right now things look pretty good, but if they turn out differently—well, don't say we didn't warn you.

Still, it's a useful term and we have chosen a variation of it—"cautiously bullish"—to describe the midyear report on railroads which Michael H. Lloyd of Salomon Brothers prepared for this issue (p. 34).

Wall Street's view of the industry matters mightily to the railroads, which is why some of them spend a considerable amount of time and money meeting with analysts and trundling them up and down the line on inspection trains. It was with this in mind that we asked Mr. Lloyd, one of the most respected transportation analysts in the business, to provide a "Wall Street view" for our midyear examination of the state-of-the-industry. The result is a thoughtful, balanced report that examines the pluses and the minuses. The bottom line: "Wall Street's crystal ball for railroads has bright sunshine beaming through some nearby dark clouds."

One of those "dark clouds" is the Interstate Commerce Commission's recent decision to modify the Railroad Cost Adjustment formula (on which cost-based rate increases are figured) by requiring railroads to pass all productivity savings through to their customers. Mr. Lloyd is not alone in his concern over the possible consequences of this. Standard & Poor's says it "will force a reevaluation of investment programs," with long-term-payback projects jeopardized (p. 9).

Another cloud is that produced by soaring railroad debt resulting from restructurings. Railroad managements, says Mr. Lloyd, are going to have to "balance Wall Street preference for the short-term stock price benefit from restructuring against the limits of prudent leverage."

This subject is dealt with at greater length in Watching Washington (p. 17), which reports on a widely-circulated paper, by analyst Isabel H. Benham, that examines the wisdom of the "high level of debt exposure" that characterizes some balance sheets. "If rail equities continue to run a collision course with rail debt, the future viability of the industry may be seriously weakened," says Ms. Benham.

Congress is also getting worried. In mid-June Senator Ernest V. Hollings (D.-S.C.) announced that the Surface Transportation Subcommittee had scheduled a hearing on legislation (S.1005) providing the ICC with jurisdiction over the acquisition of control of a Class I railroad by a non-carrier. He said the subcommittee would also examine "other acquisition, debt and leveraging questions which may affect the long-term financial health of the industry and individual carriers."

One question that dwarfs all others with respect to the short- and long-term prospects of railroads has to do with efforts to reduce high labor costs.

That is the biggest question on the minds of investors, says Mr. Lloyd. He believes that "if railroad managements can find a common denominator to satisfy their unions' needs while improving the competitive stance of railroads, the 1990s could become a golden decade for railroad investors."

The search for that common denominator is the subject of Senior Editor Gus Welty's Lines on Labor column (p. 18).

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MARKET OUTLOOK

Equipment

Amtrak: Ordered 70 material handling headend cars from Thrall at a cost of $317,000 each. Amtrak will also modify six former VIA Rail mail cars at a total cost of $1 million.

Itel Rail: Ordered 400 100-ton, 5,850-cubic-foot-capacity covered hopper cars for transportation and storage of plastic pellets from Trinity Industries at a cost of more than $22 million. Deliveries began in May and will be completed next January.

NJ Transit: An UMTA commitment to supply $211 million to NJ Transit over a three-year period, subject to annual appropriations by Congress, is designed to permit the agency to sell Grant Anticipation Notes to finance projects before the grants are actually received. Along with $90 million previously committed, the money reportedly will go toward the overhaul of 230 Arrow III cars ($178.5 million); purchase of six locomotives ($26.4 million); 50 new cars ($47 million); track improvements ($36.5 million); and signal improvements ($12.5 million).

Santa Fe: Ordered 100 five-platform double-stack cars from Gunderson at a cost of $19 million. Gunderson calls the cars "Maxi-Stack 2½" units (a variation of the Maxi-Stack III), with 48-foot wells and 125-ton trucks.

Washington Metropolitan Area Transit Authority: Will acquire 63 new rapid transit cars from Breda at a cost of $83 million, and plans to buy an additional 32 cars when funds become available. WMATA's current fleet consists of 366 Breda cars and 298 built by Rohr.

Wisconsin Central: Placed an $11-million order with Bethlehem Steel for 250 3,000-cubic-foot-capacity covered hopper cars for hauling roofing granules. Deliveries will begin in October.

Facilities

CSX Transportation: A new $5.6-million, 28,000-square-foot shop in Cumberland, Md., will be capable of performing running repairs on more than 65 cars a day.

St. Louis Bi-State Development Agency: Awarded a contract to LS Transit Systems, Inc., for final track design of the 18-mile Metro-Link light rail system.

Toronto Transit Commission: Will construct a one-mile extension to its Spadina line at a cost of $159 million (Canadian). Station and alignment designs are under study and ground-breaking will take place by the spring of 1991.

Union Pacific: Will build a $2.2-million automobile unloading facility at West Memphis, Ark., for use by Toyota Motor Sales. The terminal, scheduled for November completion, will cover 13.2 acres, all paved, and will include two 1,600-foot tracks, two buildings, and security lighting and fencing.

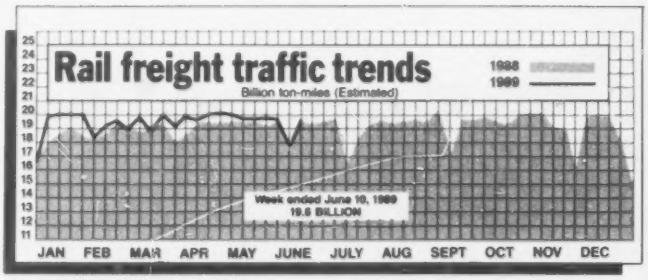
Revenue freight carloadings

Commodity	June 10 week	June 3 week	May 27 week	May 20 week	May 13 week
Grain	27,196	24,207	26,518	27,505	25,107
Other farm products	2,084	1,935	1,561	1,586	1,519
Metallic ores	21,710	23,903	23,347	23,177	21,282
Coal	130,440	118,888	124,635	126,737	127,200
Crushed stone, gravel and sand	17,014	14,842	16,697	16,405	17,054
Nonmetallic minerals	10,576	9,120	11,887	11,029	10,521
Grain mill products	10,126	8,479	10,039	10,046	10,104
Food and kindred products	8,684	7,805	8,764	8,817	8,868
Primary forest products	9,420	8,271	9,645	9,475	9,058
Lumber and wood products	6,688	6,133	7,171	6,871	6,603
Pulp, paper and allied products	10,056	10,826	10,358	10,382	10,152
Chemicals	25,788	23,839	26,857	27,344	26,273
Petroleum products	5,084	4,720	5,508	5,137	4,925
Stone, clay and glass products	10,744	9,648	11,013	10,625	10,657
Coke	5,278	5,535	5,377	5,485	5,577
Metals and products	9,322	9,271	9,941	10,383	9,702
Motor vehicles and equipment	20,167	16,709	20,484	21,091	21,192
Waste and scrap materials	8,837	7,542	9,449	9,403	9,525
All other carloads	6,570	6,318	7,990	7,236	7,250
Total Cars Loaded	345,784	317,992	347,913	348,899	344,574
% change from previous year	(.5)	3.8	(.4)	1.9	(.8)
			% change		
Cumulative total: 23 weeks		7,746,639	0.6		
Estimated revenue ton-miles (billions)	19.8	17.9	19.7	19.8	19.7
% change from previous year	.5	3.5	.0	2.6	.5
Total:		1989	1988		% change
23 weeks		445.3	439.9		1.2

Intermodal traffic

	June 10	June 3	May 27	May 20	May 13
Trailers	65,120	57,593	63,212	64,975	65,900
Containers	45,628	40,447	45,155	46,459	46,741
Total	110,748	98,040	108,367	111,434	112,641
% change from previous year	(.6)	(4.1)	(6.3)	(.1)	.4

		% change
Cumulative total: 23 weeks	2,566,152	1.0



Source: Association of American Railroads

Union Pacific: Awarded a contract to CXT for 55,000 concrete ties to be installed in 1989. This is CXT's third such contract from UP, for a total of 130,000 ties for installation on main lines in Oregon, Nevada, and Nebraska.

Wisconsin Central: Opened a new intermodal facility adjacent to its classification yard at Neenah, Wis., to facilitate next-morning delivery of trailers and containers to Chicago from cities in the Fox River area, including Appleton, Menasha, Kaukauna, Kimberly, and Oshkosh.

By MICHAEL H. LLOYD, CFA
Salomon Brothers
for Railway Age

This far in 1989, there have been no major surprises in railroad traffic trends, although automotive traffic and coal shipments (especially exports) have been somewhat weaker than expected.

During the first 24 weeks of this year, revenue ton-miles expanded by 4.2% for Class I railroads, as originated carloads contracted 0.6%. Industry organizations of coal carloads increased by 5.4%, and motor vehicles and equipment jumped by 9.5%. Chemicals also posted a healthy advance, while metallic ores and forest products declined. Elsewhere, however, declines dominated, with grain originations down by 10.0%, reflecting an anticipated drop in exports and a weakening economy led to decreases in almost every other category.

During the remaining months of 1989, we expect economic activity to be much slower than during the first quarter, with the slow pace continuing into 1990. Furthermore, automotive carloadings are likely to register year-to-year declines during the next several quarters.

The two traffic segments which have above-average growth prospects are coal and grain. Coal exports are being helped by the lessening of foreign competition as Australia has been shutting down unprofitable mines and Europe has discovered that there are more cost-efficient ways to provide jobs than with huge subsidies for coal production. Meanwhile, grain traffic southward will become much easier in a few months relative to the drought-stricken levels of last year. Even if the 1989 crops of spring wheat and corn are normal, we expect a surge in grain demand for grain cars on U.S. railroads. Furthermore, foreign demand for our high-quality metallurgical coal and ample supplies of grain may continue to bolster shipment levels for these important commodities through 1990. Of course, if the U.S. dollar continues to strengthen versus other currencies, the attractiveness of our coal and grain

...sly bullish

to foreign buyers would eventually be undermined, if it hasn't been already.

• **Earnings and stock prices.** Led by consecutive years of record revenue ton miles for railroads in 1987 and 1988, as well as a robust rate environment last year, railroad profits have been growing strongly. And the earnings momentum has been reflected in higher stock prices over the past two years.

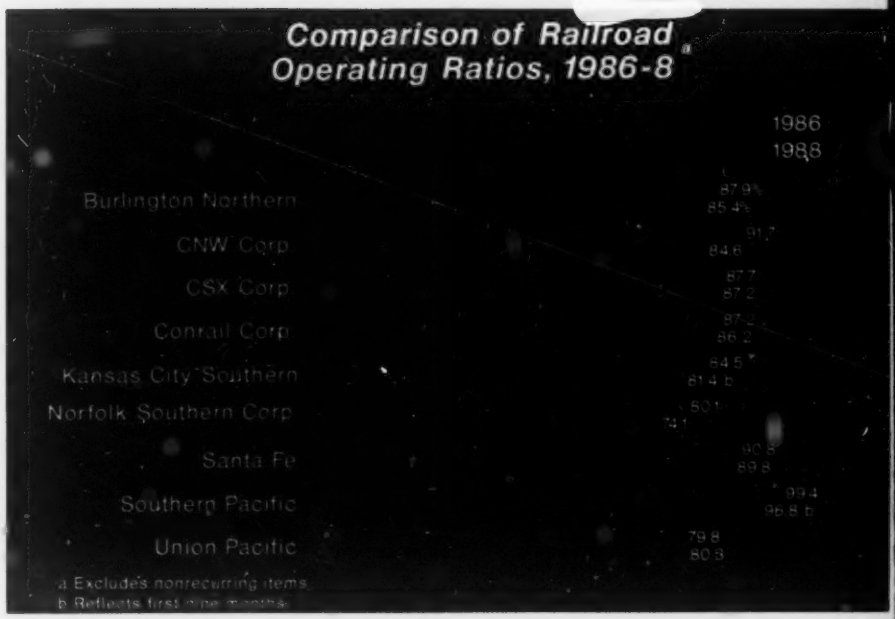
During 1987 and 1988 railroad stock prices outperformed the general stock market, as the S&P Rail index advanced by 8.6% and 16.7%, respectively, compared with gains of 2.0% and 12.4% for the S&P 500 index. This year has been more erratic with strong relative performance of railroad stock prices during January followed by two months of disappointing performance. Investors became increasingly concerned about the effect of a slowing economy on traffic and the ICC's mortal blow to quarterly rate increases with its Ex Parte 290 (Sub No. 1) decision to force the pass-through of all productivity gains to shippers. Consequently, rail stocks rose by only 4.2% during the first quarter of 1989 compared with a 6.1% gain for the S&P 500. In April the S&P rail index rallied somewhat, rising by 2.0%, while the S&P 500 rose by 5.0%, as railroad stock prices were helped by a developing consensus that we were not entering a recession but were headed for a soft landing instead. Furthermore, continued large purchases of U.S. grain by the Soviet Union led to growing optimism about strong grain exports during the second half of 1989. More important, the stock price of CNW was boosted by a takeover bid. Then, in May, Union Pacific's stock price was helped by a major stock buyback program and the S&P Rail index advanced by 3.4%, nearly matching the S&P 500's 3.5% gain. Overall, the railroad stock index rose by 15.8% during the first five months of this year, which was modestly above the 15.4% advance of the S&P 500.

We expect railroad stock prices to underperform the S&P 500 in future quarters and for the full year of 1989 because of weakened fundamentals. As mentioned earlier

year-to-year comparisons will be adversely affected by the slowing economy with industrial activity noticeably slower than during the first quarter. In particular, highly profitable shipments of automobiles and automotive parts will show negative comparisons during the second half of this year, as high inventories cause production cutbacks. Meanwhile, in the wake of the recent ICC decision on productivity pass throughs, the rate environment is not favorable and revenue per ton-mile could once again deteriorate as the year progresses. All of this adds up to an earnings scenario that could contain some unpleasant surprises, with concomitant negative effects on railroad stock prices. Consequently, Salomon Brothers Inc. currently maintains a negative stance toward railroad stock prices in general, but we continue to recommend two restructuring situations: Norfolk Southern ($36) and Union Pacific ($73). Norfolk Southern is expected to use its strong balance sheet to significantly expand the current repurchase program for its common stock. At Union Pacific, we believe the recent restructuring steps (which include the proposed sale of real estate assets and a 10% share buyback) are harbingers of future positive actions to benefit shareholders. It should also be noted that the company's top 20-25 executives have a unique incentive to help boost their stock price. If the price reaches $100 for 60 consecutive days, these individuals split $17 million. And the pot of gold gets larger at higher stock prices.

Beyond 1989, the stock price outlook for railroads could improve significantly depending on the outcome of current labor negotiations. Hopefully, railroad union leaders and members will recognize that the work rules of 70 years ago have to change, unless they want to doom the railroad industry to further loss of market share. Revenue ton-mile growth of 1.5% annually during the past ten years was half the pace of industrial production, and without a more competitive cost structure future rail traffic gains could also be disappointing. Hence, investors will be focusing on railroads' ability to reduce their expense structure, where labor costs dominate.

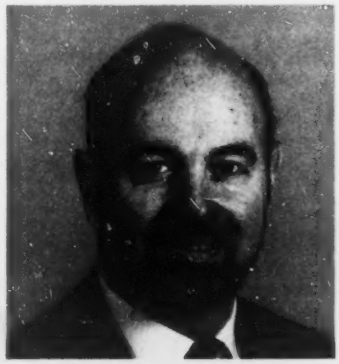
From an operating efficiency viewpoint, Wall Street has been impressed by the substantial improvement which several railroads have achieved during the past two years. While strong traffic and higher rates undoubtedly helped, the benefits of headcount reductions and the sale of short line segments have earned the investment community's admiration, especially at Norfolk Southern. Even though short line sales are now in limbo, railroads can hopefully



achieve further operating ratio reductions during the early 1990s that at least match the general gains registered during the 1986-88 period.

If railroad managements can find a common denominator to satisfy their unions' needs while improving the competitive stance of railroads, the 1990s could become a golden decade for railroad investors.

- **Congress and the ICC.** The congressional and regulatory environment for railroads appears to be stabilizing, albeit with a bigger tilt toward shippers from the ICC viewpoint. We do not expect a repeat of the close call last Fall on Senate consideration of a pro-shipper bill to alter some provisions of the Staggers Rail Act of 1980. Congress seems to be taking a wait-and-see attitude on future railroad reregulation efforts until the Administration completes its nominations for the ICC, including a new person to replace Heather Gradison. If the new addition to the ICC can avoid the label of being a laissez-faire pro-railroad advocate, Congress is unlikely to resurrect any damaging legislation (which would probably incur a presidential veto in any case). The ICC, however, may be in the midst of a shift toward new interpretations of the Staggers Act, as occurred recently regarding the pass through of all productivity savings to shippers when calculating the railroad cost adjustment factor (RCAF). The recent decision reversed a 1981 decision by the ICC on RCAF productivity, and there appears to be a shifting coalition which will bear watching. In particular, there is an outside chance that J.J. Simmons could assume the chairmanship, which could prove especially troublesome in view of some of his past decisions. Unlike the past two years, railroads now will have to keep a wary eye on the ICC but can relax their vigilance in the halls of Congress (at least for the time being).
- **What Wall Street wants to see.** The experienced investors on Wall Street have



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been justifiably impressed with the substantial improvement in the track structure of U.S. railroads during the past decade. How pleasantly rare it is today to see any mention of undermaintained roadbed or deferred maintenance. In addition, railroad managements are demonstrating a better awareness of how to better satisfy shareholders' interests. What more could Wall Street ask for?

One area of concern is the aging fleet. The average age of freight cars at even the premier Norfolk Southern Corp. has increased 14% during the past five years and now approaches 19 years. Similar aging has occurred at most other railroads and the financial community will be looking for corrective action, which is already being signaled by escalating budgets for equipment purchases.

Another point of discussion involves enthusiasm for more share buyback programs, but this could become a bed of quicksand if a recession strikes sooner rather than later. In 1988, interest expense absorbed 38% of the combined operating profit of the seven largest U.S. railroad holding companies—well above the 30% level of only two years earlier. Obviously, the recent restructurings at Burlington Northern, CSX, and Santa Fe Pacific have decreased their financial flexibility and the pending LBO of CNW would exacerbate the situation. Hence, railroad managements will have to balance Wall Street preferences for the short-term stock price benefit from restructurings against the limits of prudent leverage. Elsewhere, the financial community will continue to seek frank answers to its sometimes rude questions and will continue to applaud the refreshing candidness which typifies today's railroad executives. And, of course, railroad trips will continue to get plaudits from the kids inside the adults on Wall Street.

Overall, Wall Street is looking for reasons to be bullish on the U.S. railroad industry, which could seize some impressive cost reduction opportunities as the next century approaches. The cost benefits of double-stack container trains and improved railroad service levels could also facilitate the recapture of some traffic from the highways. In addition, there could be a new round of railroad mergers, depending on what happens with Santa Fe's railroad, which now has a new chief executive officer.

In summary, Wall Street's crystal ball for railroads has bright sunshine beaming through some nearby dark clouds. Whatever the outcome, there are exciting times ahead!■

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